

Italy

Why is the Economy Underperforming so Badly?

- Italy's GDP surprised once again to the downside, posting a decline of 0.2% QQ in Q2 14, after a disappointing -0.1% QQ in Q1. This puts Italy technically back into recession, after only one positive QQ growth rate (+0.1% QQ) in Q4 13 following nine consecutive declines. Survey-based indicators up to July are still suggesting a slightly rosier picture of modest, but positive, GDP growth. However, they have been levelling off recently (the composite PMI declined by 1.1pts to 53.1 in July), suggesting that even if a modest GDP expansion could (as we expect) happen in H2 14, the underperformance of the Italian economy relative to the rest of the euro area is likely to persist. We are revising down our forecast for 2014 average GDP growth to -0.1%, from +0.1% last month and +0.3% at the beginning of the year.
- The weakness of Italy's economy partly reflects the ECB's inability (or failure) to adequately loosen euro area monetary conditions and financing costs: overall euro area growth is modest and inflation is close to zero. Such a path implies that Italy, as a persistent growth underperformer, is likely to be in or near recession. But, in addition, the disparity between Italy's YY real GDP growth and the euro area average has expanded from 0.7pp on average between 1999 and 2007 to 1.5pp since 2011. The growth gap has worsened relative to Germany and (albeit less dramatically) relative to France, but recently it turned negative also relative to the rest of the periphery (lower YY GDP growth by 1.4pp in the past four quarters compared to Spain, Portugal and Greece on average). We reckon this growth deficit can be mainly attributed to poorer export competitiveness and the absence of the profound labour market adjustment that occurred in the rest of the periphery. Italy's real effective exchange rate, deflated by unit labour costs (IMF data) is up by 13% since Jan-08, against a 5% gain in France, a flat move for Germany and a 17% drop in Greece and Spain (-35% in Ireland and -9% in Portugal). These differences are mainly due to worse labour productivity growth and, more recently, also to a higher wage dynamic compared with other periphery countries. Italy's worse export performance (measured by export growth relative to imports in trading partners) highlights Italy's poor competitive position (see Figure 1). Corporate profits (as a percentage of value added) have stabilised only recently after a prolonged decline, leaving little room for capex spending and/or labour force expansion (see Figure 2).
- We had expected the tax rebates introduced in May (€80/month for low-income earners) and improved corporate liquidity would support a modest recovery this year. Even if this may still happen in H2 14, it seems that the long-standing structural weaknesses of the Italian economy are still prevailing, especially in the context of fixed intra-EMU exchange rates and the relatively elevated euro. The much-discussed (but scarcely implemented) structural reforms could help to boost labour productivity in the medium term, but we reckon there is little that domestic economic policy can do to lift GDP growth into decently positive territory in the near term. We expect Italy to keep underperforming the rest of the euro area.

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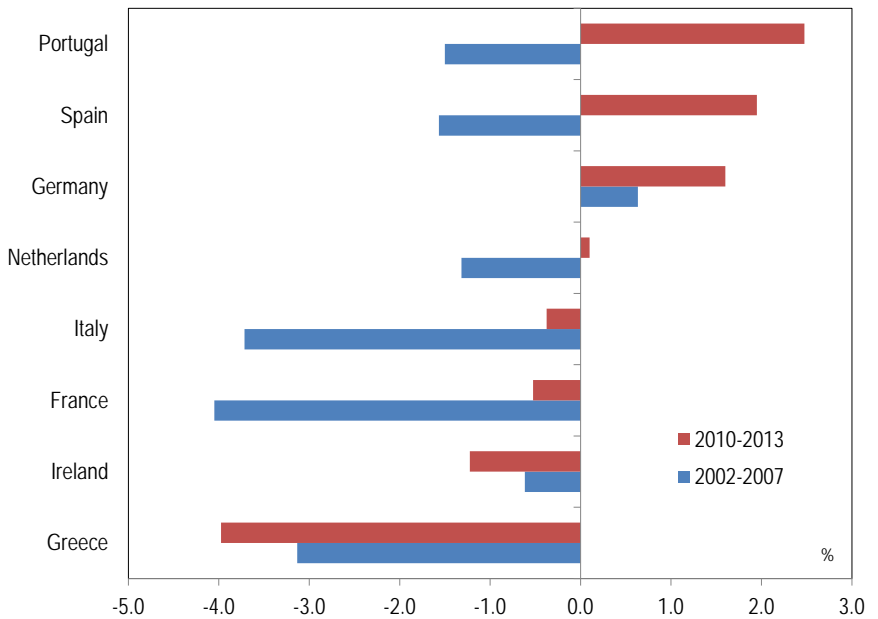
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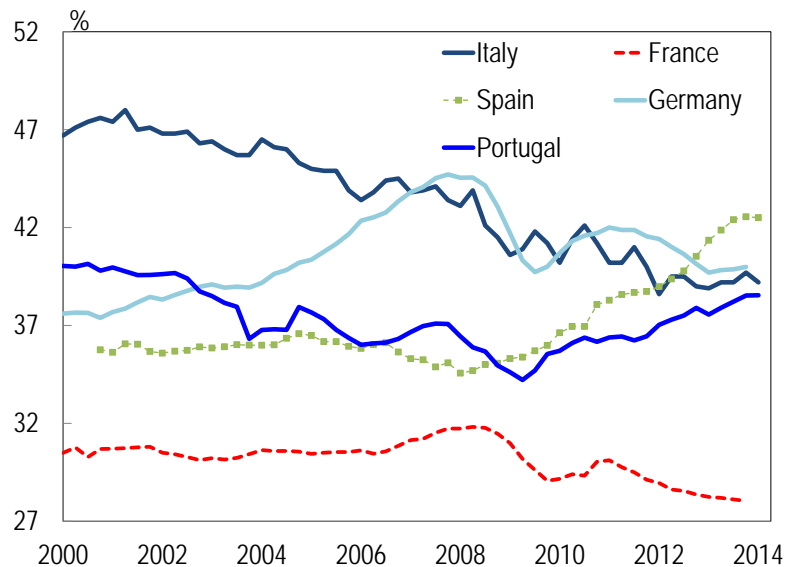
Figure 1. Selected Euro Area Countries – Export Performance Relative To Trading Partners, 2010-2013



Note: Export performance is measured as actual growth in exports relative to the growth of the country's export market.

Sources: OECD and Citi Research

Figure 2. Euro Area Selected Countries – Non-Financial Corporation Profits (Pct. of Gross Value Added), 2000-Q1 2014



Sources: Eurostat, Haver Analytics and Citi Research

Appendix A-1

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